

SECTION 1
CHAPTER 2
ANNUAL INTERNAL CONTROL REVIEW PLAN

The first step in the internal control process involves the preparation of an Internal Control Review Plan (ICRP). This plan helps institutionalize the internal control process within the bureau by involving all levels of management in its preparation and approval. The ICRP represents the bureau schedule for performing financial reporting and programmatic internal control assessments for the current fiscal year and/or later years (usually covering a five-year period, but some reviews are scheduled annually). This list includes not only the internal assessments described in this section, previously known as management control reviews, but also the list of financial statement-related internal controls that will be tested as well (as discussed in the next section).

An ICRP must summarize a bureau's components; identify the relative priority ranking of each component as high, medium, or low risk activity; establish the type of control evaluation to be conducted and the year in which the evaluation is to be completed; and assign the responsibility for conducting the planned evaluation. The annual review plan may have reviews of key controls in the financial areas that do not result in an AICR-like deliverable that is surnamed and provided to PFM.

At a minimum, the plan should be updated annually. The update consists of adjusting the plan to accommodate Departmental Functional Reviews (DFRs); competitive sourcing; new components, programs, or reporting systems; changes in priority; the completion of control evaluations and corrective actions; and any additional information available on the status of controls. Annual updates should coordinate review activity to avoid redundancy by integrating, to the maximum extent possible, internal program, functional, and operational reviews, GPRA performance assessments, management studies, OIG and GAO audits, or any other independent review efforts.

The ICRP is a useful management tool for monitoring the Internal Control Program. Stages in developing the plan follow.

ESTABLISH AND MAINTAIN COMPONENT INVENTORY

The first stage in preparing the ICRP is to establish and maintain an inventory of bureau components. Internal controls should be designed to provide reasonable assurance regarding prevention or prompt detection of unauthorized use or disposition of assets. As a result, management is responsible for developing internal control components which provide an accurate reflection of financial reporting, program functions, and administrative activities of a specific bureau. Developing and maintaining an inventory of those components is the first stage in the review planning process.

Definition

A component is defined as a major program, administrative activity, organization, or functional subdivision of a bureau or office that requires one or more separate systems of internal controls. However, it is suggested that bureaus define their programs and administrative functions along budget and financial statement line items or other similar segmentation such as GPRA-defined activities for performance assessment and reporting purposes.

Scope and Size

Components should be properly sized to facilitate internal control assessments. Each component should:

- Contain sufficient information to support management's assertion;
- Include appropriate representations from officials and personnel responsible for monitoring, improving, and assessing internal controls; and
- Be documented appropriately.

Bureau component inventories should include a specified number of functional components. These components are functional activities generic to all bureaus and offices. They are defined by PFM as DFRs; however, the internal control assessment guidelines for the functional activities are issued by the responsible Assistant Secretary - Policy, Management and Budget (Assistant Secretary-PMB) office. Examples of DFRs include Acquisition Management, Information Technology Centers, Cash Management and Debt Collection, Property Management, and Travel.

Departmental and PMB offices should include as components only those programs or functions for which they have operational, as opposed to discretionary or policymaking, responsibilities.

Annual Update of Inventories

Component inventories should be updated annually before the ICRP is developed. This annual update is to ensure that the inventory:

- Includes all programs, organizations, or financial reporting functions which may encompass one or more systems of internal control;
- Addresses all automated data processing systems, either as a separate component or an integral part of a program component; and
- Breaks out components in such a way that each component could be reviewed in an efficient, reasonable, and logical manner.

Changes in budgetary resources assigned to a component or changes in mission may lead to consolidation or splitting of a component. Other items to consider when updating the inventory are new components, obsolete components, changes in the nature or scope of any components, and past experience in handling components.

Retention of Documentation

The ICC should maintain the current list of components as supporting documentation. This list should include a brief narrative description of each component's scope. This listing is the basis of the Plan.

REVIEW PRIORITY RATINGS (Risk Assessment)

The second stage of the review planning process is to evaluate the risk associated with individual components and assign each component an appropriate rating (high, medium, or low risk).

Definition

Risk is defined as the probability of an unwanted occurrence. Evaluation of risk is the judgmental review by bureau officials of the susceptibility of all the components to the occurrence of waste, loss, unauthorized use, and/or misappropriation. The bureau/office should evaluate management's processes for determining the level of risk related to internal controls over programs and financial reporting.

Scope

Ideally, assessments of risk should be completed for all components every year. Since the purpose of prioritizing components is to provide a basis for determining the appropriate nature, scope, and frequency of reviews, all components at least should be assessed in the established cycle.

Process

The review priority rating should be based on total organizational knowledge of the component and can be accomplished by gathering knowledgeable staff around a table for discussions about the components. Documentation of the process used and the conclusions reached should be retained for a minimum of five years for future reference by bureau officials, PFM, or OIG staff.

To assist in the priority rating process, the Department has designed the Priority Rating Worksheet. The worksheet, Exhibit 1 (or a comparable bureau-designed alternative), should be used in gathering relevant information prior to meeting with management officials as well as documenting decisions reached during roundtable discussions.

Appropriate consideration should be given to previous control assessments such as audit reports; internal control evaluations; the degree and timeliness of correcting known weaknesses; and institutional knowledge of the component. Other considerations in assigning priority rankings include factors that would:

- Prevent management from meeting program or financial reporting objectives and goals;

- Subject management to unwarranted potential loss of assets and revenues;
- Cause management to provide unreliable information and reports about the component;
- Encourage departures from established procedures; and/or
- Create adverse public opinion.

A component with a material weakness should be rated high until the weakness is corrected.

Items which may be considered when assessing risk and assigning the priority ratings are:

- **Control Environment** - The control environment is the organizational and structure and culture created by management attitude and employees to sustain organizational support for effective internal controls. An analysis of the control environment will provide an assessment of management's commitment to fostering an organizational tone that is conducive to providing a strong and effective control environment. The factors that influence the general control environment are: Define areas of authority and responsibility; appropriately delegate the authority and responsibility throughout the agency; establish a suitable hierarchy for reporting; support appropriate human capital policies for hiring, training, evaluating, counseling, advancing, compensating and disciplining personnel; and uphold the need for personnel to possess and maintain the proper knowledge and skills to perform assigned duties as well as understand the importance of maintaining effective internal controls within the bureau.
- **Risk Assessment** - Risk assessment is an entity's internal process for identifying, analyzing, and managing risk relevant to achieving the objectives of reliable financial reporting, safeguarding of assets, and compliance with budget and other laws and regulations. Management should make a thorough identification of all internal and external risks that may prevent the organization from meeting objectives. The major factors that affect the risks of a component are: Changes in the operating or statutory environment; new personnel who may have a different focus on internal control; new or significantly changed information systems; rapid growth of programs which can strain controls; new technology; new programs or activities which may introduce new control risks; restructurings or budget cutbacks; and adoption of new accounting principles which may have an impact on the financial statement. Identified risks should then be analyzed for their potential effect or impact on the agency. The various types of risks which may be identified are: inherent, control, combined, and/or fraud. See the Key Terms section of the handbook for a description of the various types of risk.
- **Control Activities** - Control activities include policies, procedures, and mechanisms in place to help ensure that agency objectives are met and that management's assertions in financial reporting are valid. Due to frequent changes in information technology, human resources, and program functions, controls should be monitored and adjusted to remain effective.
- **Information and Communication** - Information should be communicated to relevant personnel at all levels within an organization. This communication should not only exist

with the organization, but should also encompass communicating with external organizations, whether providing information or receiving it. Management should ensure that a system is in place to identify and record pertinent operation and financial information relating to internal and external events.

- **Monitoring** - Monitoring the effectiveness of internal controls should occur in the normal course of business. Periodic reviews and reconciliations of data should be conducted regularly. Management should ensure that: employees know their assigned responsibilities for internal control and control monitoring; procedures exist to ensure that all audit findings and other reviews are promptly evaluated; response decisions are made appropriately; and that corrective actions will resolve the issues promptly.

SCHEDULING INTERNAL CONTROL ASSESSMENTS

The third stage in preparing an ICRP is to schedule internal control assessments for each component. It is suggested that these assessments be scheduled over a cyclical number of years (unless required annually) to help assist bureaus with the review planning process. Scheduled internal control reviews that have been conducted should be documented.

Definition

An internal control assessment is a systematic assessment of a control system to determine if the controls in operation are adequate to provide reasonable assurance of meeting component objectives efficiently and effectively and safeguarding government resources. The two types of control evaluations are Internal Control Reviews (ICRs) and Alternative Internal Control Reviews (AICRs). Emphasis should be placed on using the type of review which is the most efficient and cost effective in assessing a component's system of control. ICRs are control evaluations which cover all significant areas or activities (event cycles) of a component. An AICR allows a bureau to narrow the scope of the review and focus attention on areas or activities of a component which have the highest potential for ineffective and inefficient operation or loss of government resources. Examples of AICRs include GAO and OIG audit reports, GPRA performance assessments, program evaluations and internal studies, reviews of financial systems and applications, Congressional reports, and the automated assessment approach. ICRs are control evaluations which cover all significant areas or activities (event cycles) of a component.

Scope and Frequency

The Department has decided that Internal Control Reviews (ICRs) are to be done on all controls or program areas considered to be of high risk. As discussed later in this handbook, since an ICR requires a description of all event cycles and analysis of control objectives and techniques, testing is normally very detailed and extensive. When the level of risk for controls or program areas is considered to be low, the Department has decided that an Alternative Internal Control Risk is appropriate because it is generally less paper intensive and more cost effective and efficient. For program areas considered to be medium risk, it is management's discretion as to whether the ICR or AICR is more appropriate; the decision to use the ICR or AICR should be

based on the visibility of the program, the dollar impact of the program on outside entities (public or governmental), etc.

High risk activities should be given priority in the planning and scheduling of reviews. AICRs should be combined with existing bureau management review processes as much as possible. Bureaus are encouraged to consider reviewing all components ranked as high at least every three years; components with a medium or low priority ranking should be evaluated, at least every four or five years, respectively.

Retention of Documentation

The ICC is required to maintain current evaluation of risk assessments for each component for a minimum of five years, including documentation supporting the review priority ranking assigned. This documentation should demonstrate the basis for the priority rankings. It is suggested that each component's priority ranking be listed in the ICRP.